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SUBJECT: Uruguayan Economists Weigh In on Global Crisis

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SUMMARY

¶1. (SBU) SUMMARY: Uruguayan economists expect the global financial crisis, lower commodity prices and economic slowdown to slow growth in Uruguay to an anemic 1-3% in 2009. Despite this, observers believe the GOU is in a good position to weather the downturn, with government spending financed through the end of 2010, open lines of credit with international financial organizations, and healthy levels of hard currency reserves. Debt to GDP ratio is substantially improved since the 2002 economic crisis, but the strengthening dollar and increased GOU spending threaten to push it back upward. Argentina is a major point of concern, with many predicting significant economic fallout there within months, which would have a strong negative impact on Uruguay. END SUMMARY

BOOM TIMES ARE OVER...

¶2. (SBU) Uruguay is feeling the effects of the global economic downturn, especially as commodity prices fall and exports decelerate. A common refrain from economists is that Uruguay's position in the region tends to amplify external shocks. When times are good, Uruguay exports its commodities directly to the world as a whole and provides many inputs to the Argentine and Brazilian economies which do well under the same circumstances. When prices fall and exports drop, Uruguay loses twice, they say. Local economists across the board predict Uruguay's GDP growth to drop as low as 1%-3% in 2009, a sharp fall from an annual high of 13% during the first two quarters of 2008 (ref A) and sustained rates of growth above 7% since 2005. Peso depreciation is expected to take its toll, with the GDP (expressed in U.S. dollars) falling from about 28 billion to 23 billion. If this bears out, it will result in a substantial increase in the debt/GDP ratio, a rising debt burden that would constrain public spending, and possibly negatively impact Uruguay's country risk rating, future financing options, and access to credit. Economists expect Uruguay will allow the dollar to rise to 22-24 pesos/dollar (at the time of this cable it was 23.4), but say the country does not have further room to maneuver due to the high dollarization of its economy.

...BUT GOU SPENDING REMAINS STEADY

¶3. (SBU) With the dipping economy comes the prospect of lower tax revenues, despite the fact that public spending is already locked in through the end of 2010, based on previous, fatter projections. Fernando Lorenzo, former Director of the Macroeconomic Unit at the Ministry of Economy, said the GOU has systematically adjusted its expected revenue figures (and spending) upward in the past four years in line with the previously strengthening economy. Other economists told econoff that the GOU did not plan for a rainy day, but instead planned as if the "best case scenario" would continue unabated. Opposition Senator and former Minister of Economy Isaac Alfie was also critical of increased government spending as a percentage of GDP under the Frente Amplio government.

¶4. (U) In contrast to Senator Alfie and orthodox economists who have been critical of high spending levels, Minister of Economy Alvaro Garcia presented statistics to Congress on October 29 that highlighted the increase in social spending during the Frente Amplio government. Such spending increased from 36% to 49% of total spending from 2004 to 2009 and was partly enabled by the drop in debt interest payments from 31% to 18% of total spending. Garcia emphasized that such spending increases were essential to speed recovery from the 2002 financial crisis and combat rising poverty levels, unemployment, and falling salaries. Poverty levels had increased from 17% to 32%, unemployment from 10% to 13% and salaries fell 20% during the previous administration (relative to pre-crisis levels). As of mid-2008, the Vazquez government, by increasing social spending and buoyed by remarkable economic growth, had lowered poverty to 22%, kept unemployment less than 8% and achieved a 13% increase in salaries - a good return on investment in Garcia's mind.

ECONOMY REMAINS REASONABLY SOUND

¶5. (SBU) Despite expectations that the economy in Uruguay will slow substantially, economists pointed out that the fundamentals remain strong and Uruguay is better prepared today as a result of policies implemented since the crisis in 2002. Lorenzo noted that investment (both foreign and domestic) remains very strong and continues to grow. He cited COMAP, the agency that approves tax incentives to investment projects, which reported that USD 800 million in investment projects were approved in 2008, compared to a USD 320 million in 2007. The GOU has publicly stated that Spanish paper giant ENCE continues to progress toward constructing its USD 1.4 billion pulp mill that will be the largest investment project to date in Uruguay. Lorenzo also pointed out the GOU's success in pre-financing its spending through the end of 2010 and in acquiring lines of credit with international financial organizations to back that up.

¶6. (SBU) Economic observers note that Uruguay has sufficient hard currency reserves to protect its currency and inject money into the economy if needed. While the GOU boasts more than USD six billion in reserves, Economists Michelle Santo and Alfie suggest the actual figure of available reserves is much lower, although still adequate since as much as USD three billion are private banks' reserve requirements held by the Central Bank. Santo also said reserves could drop if local investors stop rolling over short term GOU debt, since excess liquidity would put upward pressure on the dollar, forcing the Central Bank to sell hard currency. Santo was critical that the GOU had not bought reserves with fiscal surplus, but rather through debt, either with private banks or investors.

¶7. (SBU) Santo said Uruguayan banks have excess liquidity but are reluctant to loan it since (unlike the 2002 crisis) they believe their headquarters may be unable to assist in case of local trouble. He does not foresee any run on deposits against government-owned Bank of the Republic (BROU) or private foreign-owned banks. Also, he pointed out that the banks' credit is in better shape than in the past, as bank supervision has greatly improved.

WATCHING THE SLOW-MOTION TRAIN WRECK NEXT DOOR
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¶8. (SBU) Uruguayan economists generally dedicate a substantial portion of their energy to analyzing their larger neighbors. While generally comfortable with Brazil's position (Uruguay's number one trading partner), all economists we have talked to have been extremely bearish about prospects in Argentina, adding to the public's general malaise about potential effects on Uruguay. As a member of an economic panel, Senator Alfie predicted that economic problems in Argentina were "certain," while Brazil could also stumble. Argentina is a country without credit, which limits its ability to adjust to economic changes. Its ability to purchase dollars is limited to those entering the country through trade, raising the chance that the Central Bank will be unable to adequately defend the peso. Alfie said he had never seen a government itself initiate a run on the banks like Argentina just did, referring to the GOA's October 21 announcement that it would re-nationalize its pension program. Meanwhile, Santo predicted that

before year-end 2008 Argentina will suffer a capital outflow crisis that will end in a sharp increase of the dollar or in a new default.

WHAT THE EXPERTS ARE WATCHING

¶9. (SBU) Economists told econoff they are keeping an eye on the unemployment rate as employment levels are hard to recoup at the end of a crisis, a lesson which Uruguay learned the hard way during past crises. The University of the Republic's Institute of Economics predicted employment would grow 2% in 2008 (compared to 5% growth in 2007) and stagnate in 2009. On government spending, Economist Javier de Haedo predicted that good summer rains could return hydroelectric power to normal levels, offsetting the huge 2008 expenditures on fossil fuels to supply the grid. Lower fuel prices will alleviate some of the pressure even if drought-like conditions persist. Senator Alfie is keeping an eye on financing availability for large projects planned by the state oil company and utilities, including connecting Uruguay's electrical grid with Brazil. Finally, Senator Alfie reiterated his public support for a free trade agreement with the U.S., saying trade is the motor for growth and it is important to have access to such a critical market that he believes will be the first to recover from the current global downturn.
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